



Surging Ahead:

Amidst One of the Tightest Labor Markets on Record, Demand Is Thriving

What Lies Ahead?

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LABOR MARKET OUTLOOK
JULY 2023



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Quarterly Labor Market Outlook

July 2023

Introduction

Despite persistent recession fears and aggressive tightening measures by the Fed over the past year, the US economy has proven to be resilient. American consumers, dipping into the savings they accrued during the pandemic, keep increasing their spending. Recent economic indicators even suggest an upward trend in the economy.

In the first half of 2023, overall job growth remained strong. The primary reason for this positive trend, particularly in job growth, is the robust recovery of in-person service industries such as restaurants, hotels, entertainment, and healthcare, as well as in government. While job growth in these sectors is slowing down, it is projected to remain higher than normal for the rest of 2023.

Not all is rosy. Consistent with their sectoral composition, the jobs being created through this boom have largely been lower-wage service jobs. What's more, another factor contributing to the rapid job growth and tightened labor market is sluggish productivity growth. With productivity stagnant, any economic growth has to translate directly to a growing demand for labor.

But supply is finally rising to demand. In contrast to 2022, it's evident in 2023 that the labor force is far from stagnant. Higher wages are attracting more individuals into the job market. Along with a significant influx of immigrants, the working-age population is no longer on the decline.

Still, the labor market remains extremely tight, although slightly less so than in 2022. Finding qualified workers is a considerable challenge. Despite a decline in 2023, quit rates are still higher than pre-pandemic levels. As a result, wages and prices are rising rapidly, rebuffing the Fed's attempts to counteract inflation. Although inflation is on a downward trend, the descent is slow, potentially leading to a new equilibrium level of about 3.5-4%, rather than the Fed's 2% target. If inflation stabilizes around 3.5-4% for an extended period, inflation expectations will start to align with actual inflation. Bringing inflation down to 2% becomes significantly more challenging if economic actors anticipate inflation to sit at 3.5-4% and will probably require a recession and job losses.

With signs of economic improvements and increased optimism, coupled with the Fed's hesitancy to continue hiking interest rates, the likelihood of a recession in 2023 is decreasing. At the same time, aligning the current trajectory of job growth and labor market tightness with the Fed's target of 2% inflation seems incompatible. The battle to curb inflation will likely persist into 2024, a key election year. As before, any decision by the Fed to take a more aggressive stand against inflation could still take the wind out of the economy's sails.

Beyond the prospects for recession over the next several quarters, there are longer term implications to what is playing out in today's

labor market. With so much labor shortage concentrated in manual work occupations, as manifested in unusually high quit rates and wage growth, the wage gap between college-educated workers and others is shrinking.

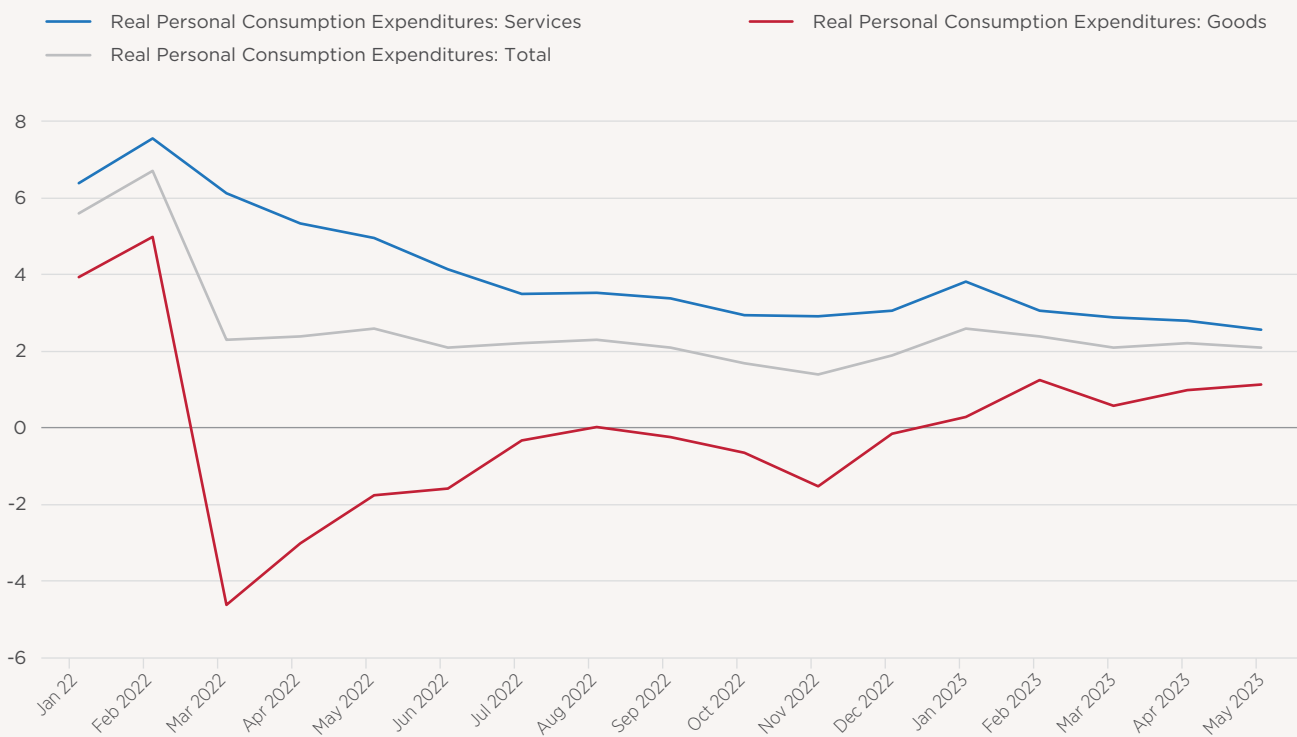
That’s an important victory for wage equality but it has also contributed to a rapid decline in college enrollment that could have significant consequences for competitiveness of the American workforce in years to come.

A consumer-driven economy continues to grow

For over a year the Federal Reserve has been rapidly raising interest rates to slow down the economy, with mixed results. Some parts of the economy are slowing down but consumer spending, which is about 70% of the economy, continues to solidly grow.

There will be no recession, loosening of the labor market, or a significant decline in wage growth, with consumer spending growing at 2.5% rate.

12-month growth rate in Real Personal Consumption Expenditures



Source: Bureau of Economic Analysis

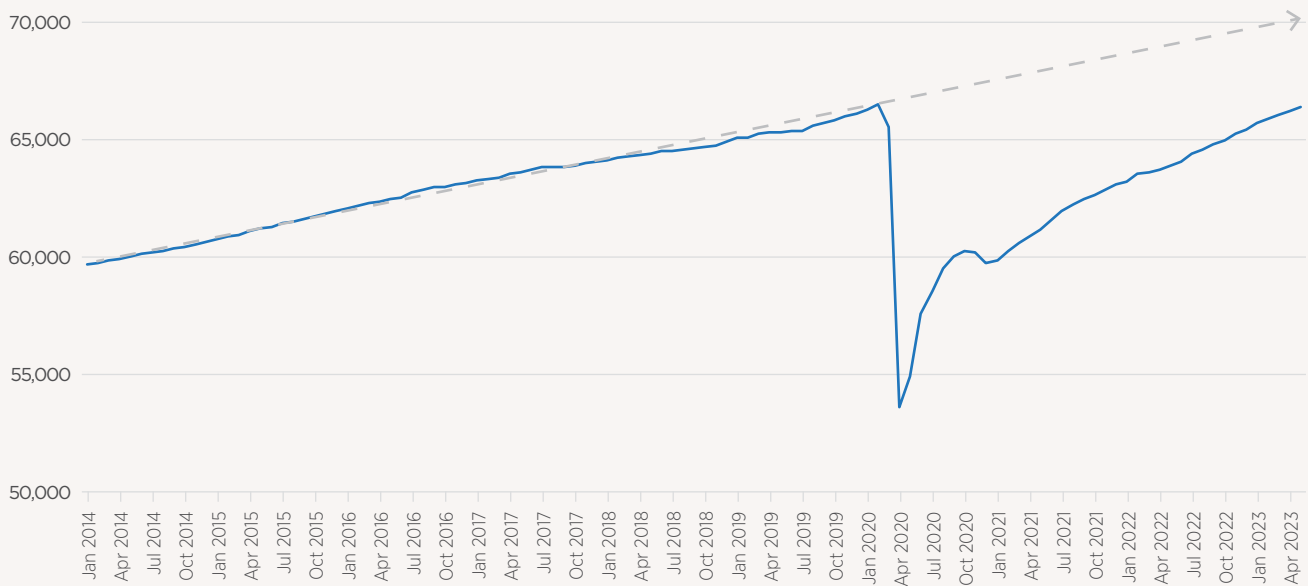
The economy is slowing, yet job growth remains impressively strong. Over the past year, sectors such as health, social assistance, leisure and hospitality, personal services, and government have been the major contributors to job growth. Together, these sectors account for roughly 42%

of all jobs and were among those hit hardest during the pandemic. These industries are still rebounding from the pandemic and have not yet established their new norm. As a result, their current job growth rates are significantly above historical trend.

It is only now that job numbers in these sectors have reached their pre-pandemic peak. However, by extrapolating the job growth trend from the pre-pandemic years to June 2023, it becomes clear that several million “catch-up” jobs are likely still forthcoming.

Although job growth within these industries can be expected to decelerate over the next year as employment fully recovers, it will probably stay unusually high. By contrast, in the remaining sectors of the economy, job growth is already slowing down, a trend likely to persist into the following year.

Employment in health, social assistance, leisure and hospitality, personal services and government



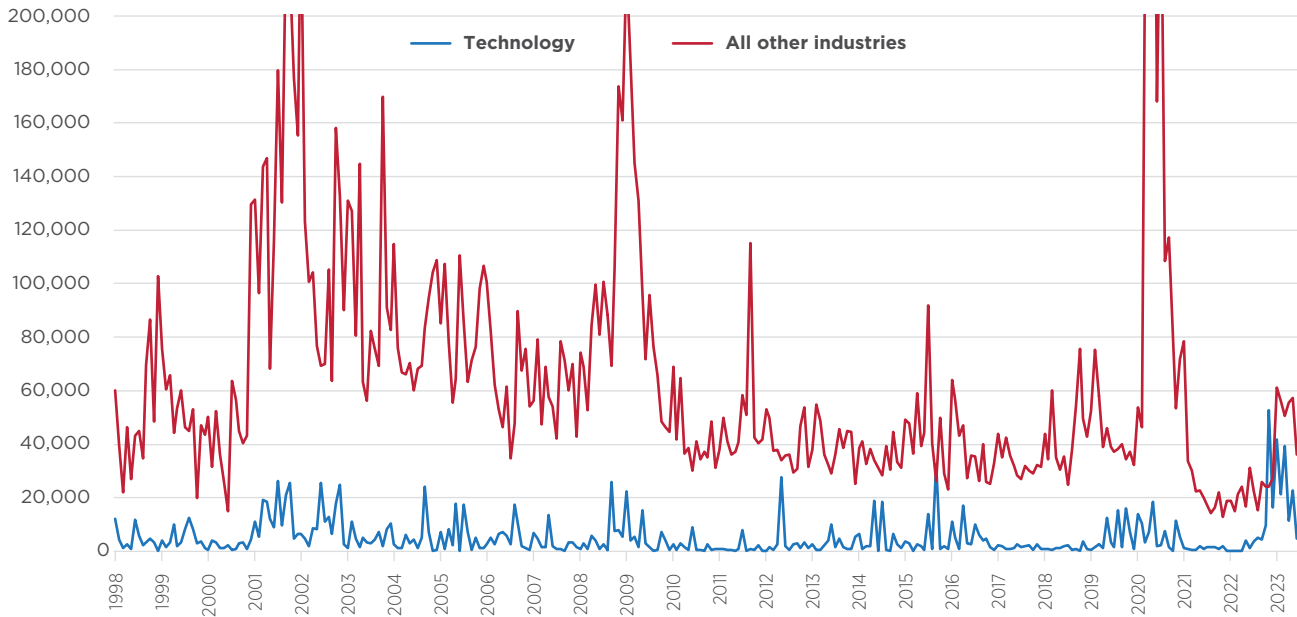
Source: Bureau of Labor Statistics and the Burning Glass Institute

Layoffs rates are still low, except in the technology sector

The economic slowdown has resulted in an increase in layoff announcements, though in most industries, the number of layoffs is at or even below historical norms. However, in the technology sector, layoffs have reached historic highs, dwarfing levels seen during the financial crisis and the pandemic. The reasons behind these exceptionally high layoffs in tech aren't entirely clear, but here are a few potential explanations:

1. The growing pressure to cut costs as economic growth decelerates globally.
2. The tech boom of the past decade has fed a hiring frenzy. Intense competition for talent led to over-hiring that has translated to an unusually high number of underutilized workers.
3. Cooling valuations together with a drying up of credit in the wake of the collapse of Silicon Valley Bank, which funded many tech companies in the global epicenter of the sector, has decreased the availability and increased its cost.
4. Tech companies, often early adopters of new technology, might already have plans to leverage new AI tools and eliminate positions in highly impacted roles.

Announced Job Cuts



Source: Challenger, Gray & Christmas

Productivity growth continues to disappoint

The coexistence of weak economic growth with robust job growth has resulted in disappointingly low labor productivity growth. Over the thirteen quarters since the onset of the pandemic recession, labor productivity has increased a meager 3.5%. This stands in stark contrast to previous recession episodes where labor productivity experienced much more rapid growth.

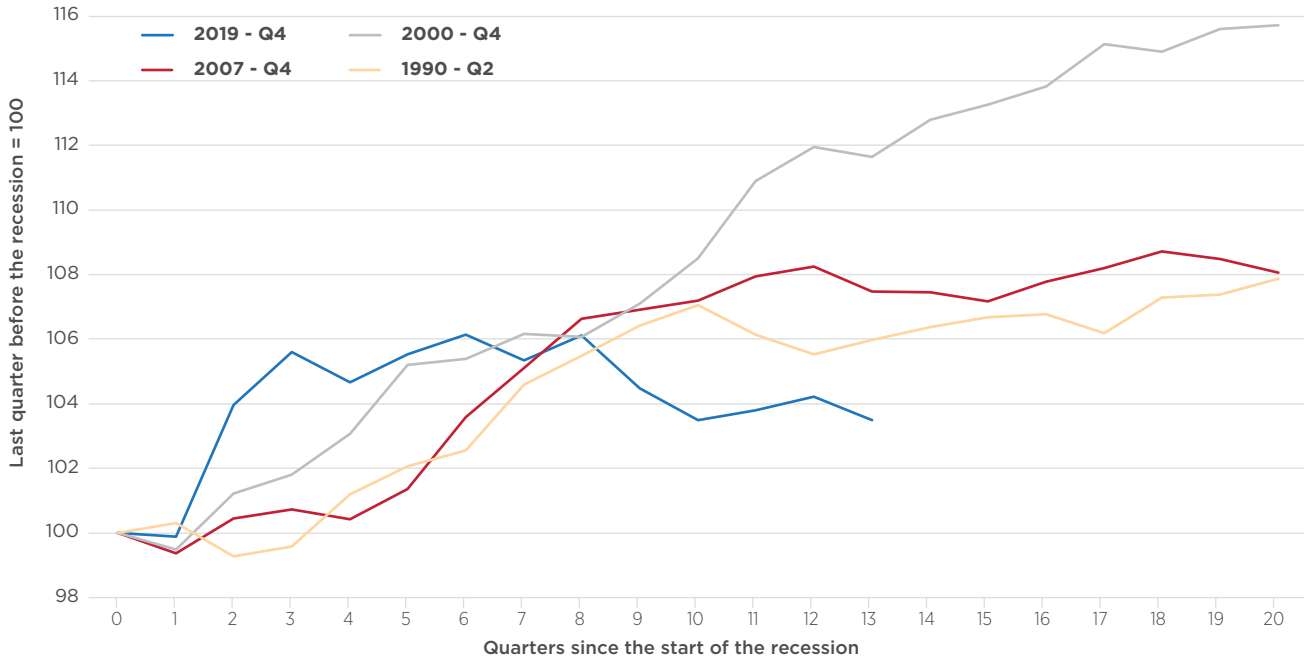
This unfortunate trend continues a decade-long pattern of weak productivity growth preceding the pandemic – a global phenomenon, not limited to the US. The most obvious opportunities to achieve labor efficiencies by replacing workers with technology were largely implemented before 2010. Since then, despite all of the headlines, the progress of further automation has been sluggish.

To compound matters, the pandemic may have sparked economic dynamics that are further decelerating productivity growth. Elements such as the transition to remote work, the decline in hours worked, the phenomenon of

quiet quitting, and declining college enrollments could all be part of an “ambition recession” – a de-emphasis on one’s career. This shift in priorities could potentially be connected to the lackluster productivity growth observed since the pandemic’s outbreak.

The implications of sluggish productivity growth are twofold, impacting both the short-term and long-term economic landscapes. In the short term, the inability to ramp up production without adding more workers contributes significantly to ongoing labor shortages. In the long run, productivity growth assumes even greater importance as our expectations of rising living standards hinge on a growing value of our labor. However, there are reasons to maintain optimism about the future of productivity growth. Rapid advances in artificial intelligence and large language models (LLMs) are poised to enhance worker productivity significantly and elevate the overall productivity level of the U.S. workforce in consequence.

Labor productivity trajectory during the last 4 recessions



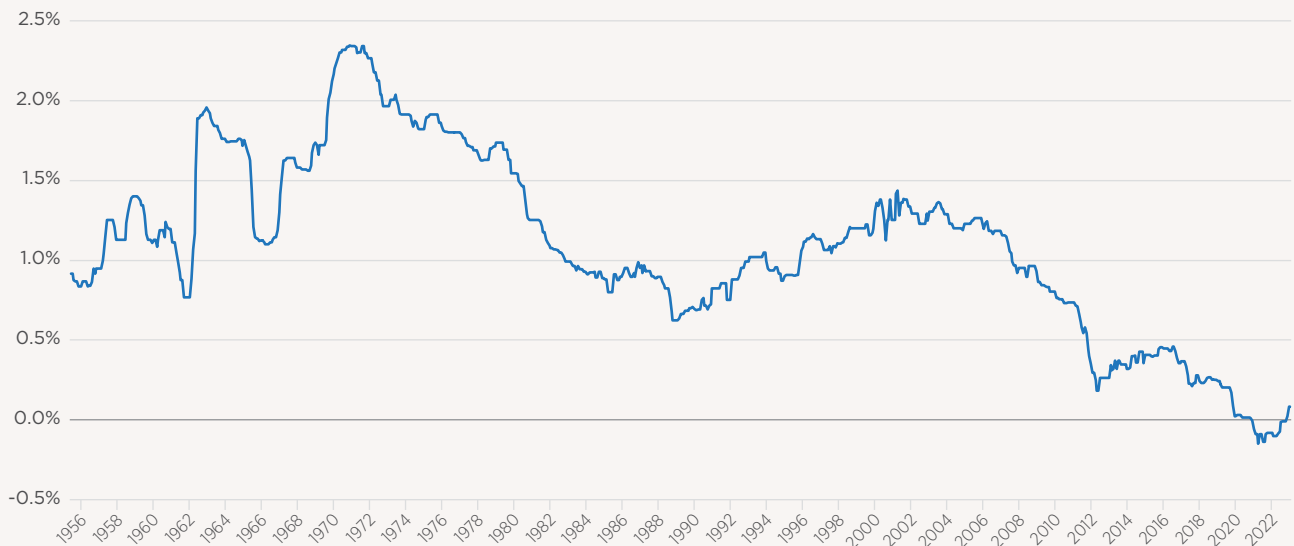
Source: Bureau of Labor Statistics

Labor supply is still growing

One of the main labor market narratives at the end of 2022 was the stagnation in the US labor force. This narrative significantly changed in the first half of 2023, for several reasons:

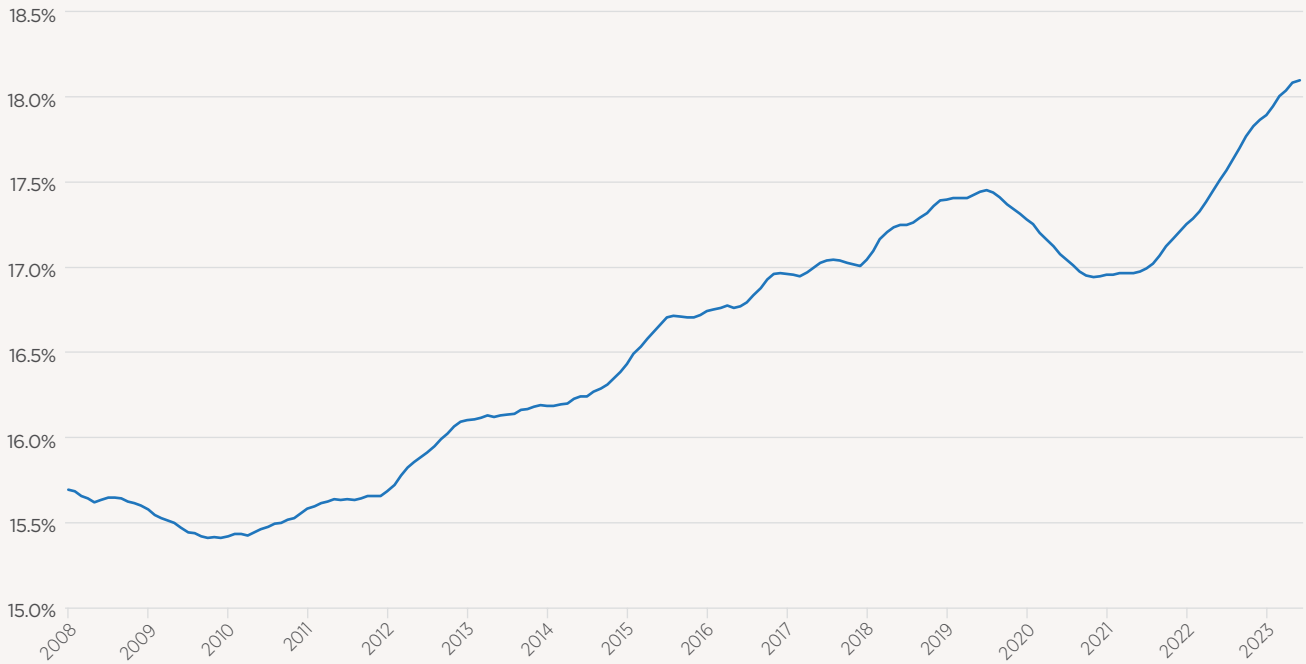
First, growth in working-age population moved back to positive territory, albeit slightly, after shrinking for the first time in American history. The reason for the improvement is a massive inflow of immigrants over the past two years.

Monthly Working Age Population Growth Rate — 12-Month Moving Median



Source: Bureau of Labor Statistics and the Burning Glass Institute

Working-age population: Share of foreign born, 12-month moving average

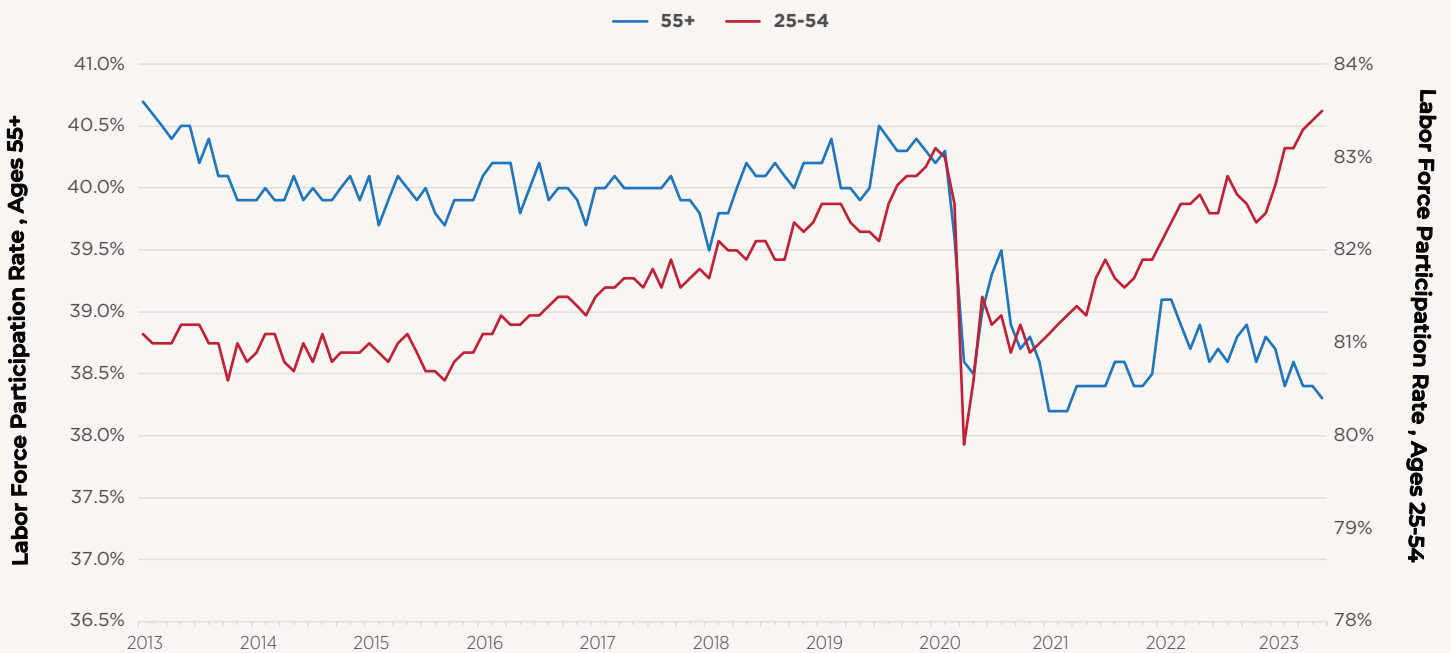


Source: Bureau of Labor Statistics

Second, and more importantly, there has been an unprecedented growth in the labor force participation rate of prime age (25-54) workers in recent months, with high wages driving

more people to the labor market. Among the older (55+) population though, the labor force participation rate remains stalled.

Labor Force Participation Rate



Source: Bureau of Labor Statistics

Labor market tightness and wage growth remain elevated

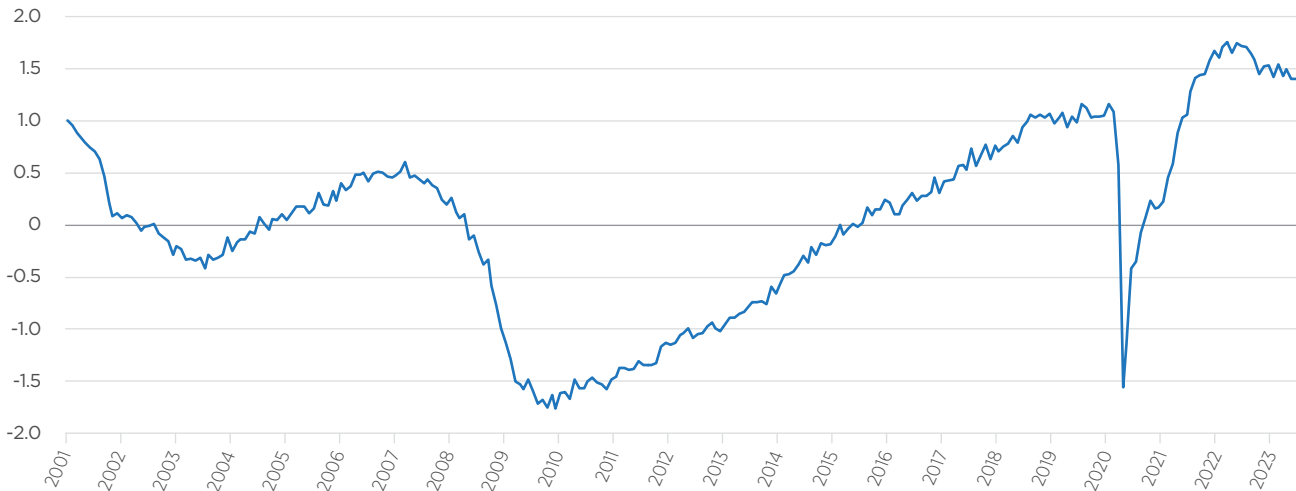
Wage growth, while slowing a little, remains well above pre-pandemic rates, despite the unemployment rate being comparable to pre-pandemic rates.

One explanation suggests that the unemployment rate doesn't provide a completely accurate picture of how tight the labor market is. The chart below illustrates our Labor Market Tightness Index, which combines a number of top indicators of labor market tightness, including the unemployment rate. According to this index, over the past two years, the labor market

has been considerably tighter than what the unemployment rate alone might imply.

While the Index has dipped slightly over the past year, it remains in an exceptionally tight range. This is not surprising given a robust pace of job growth, a continued onslaught of baby boomer retirements, and essentially zero growth in the working-age population. The minor decrease in labor market tightness suggests that wage growth is likely to remain high unless there's a substantial decrease in job growth.

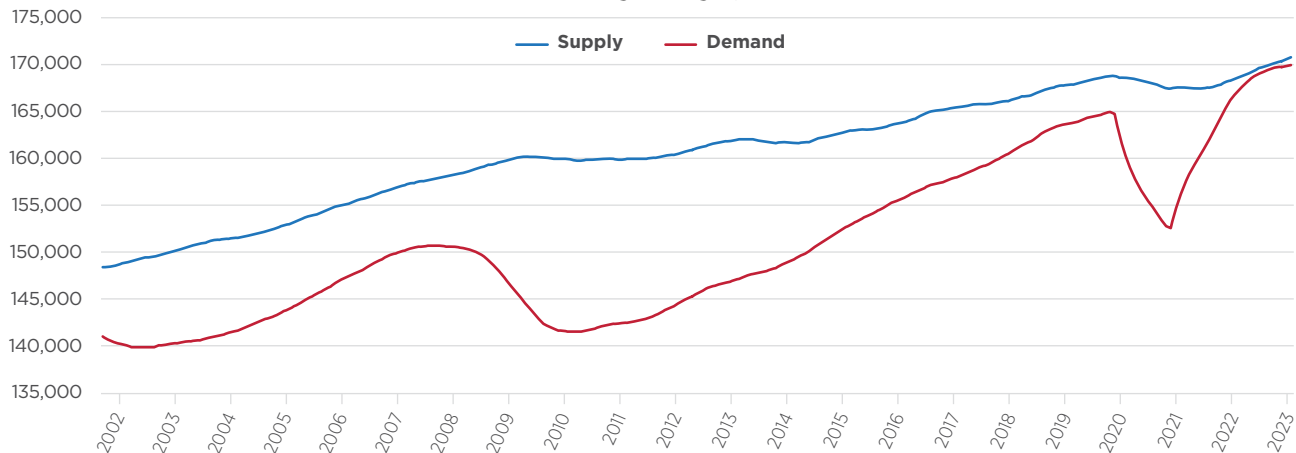
Labor Market Tightness Index – June 2023



Source: The Burning Glass Institute

Supply: People who want a job | Demand: Employment + Job Openings

12-month moving averages, thousands



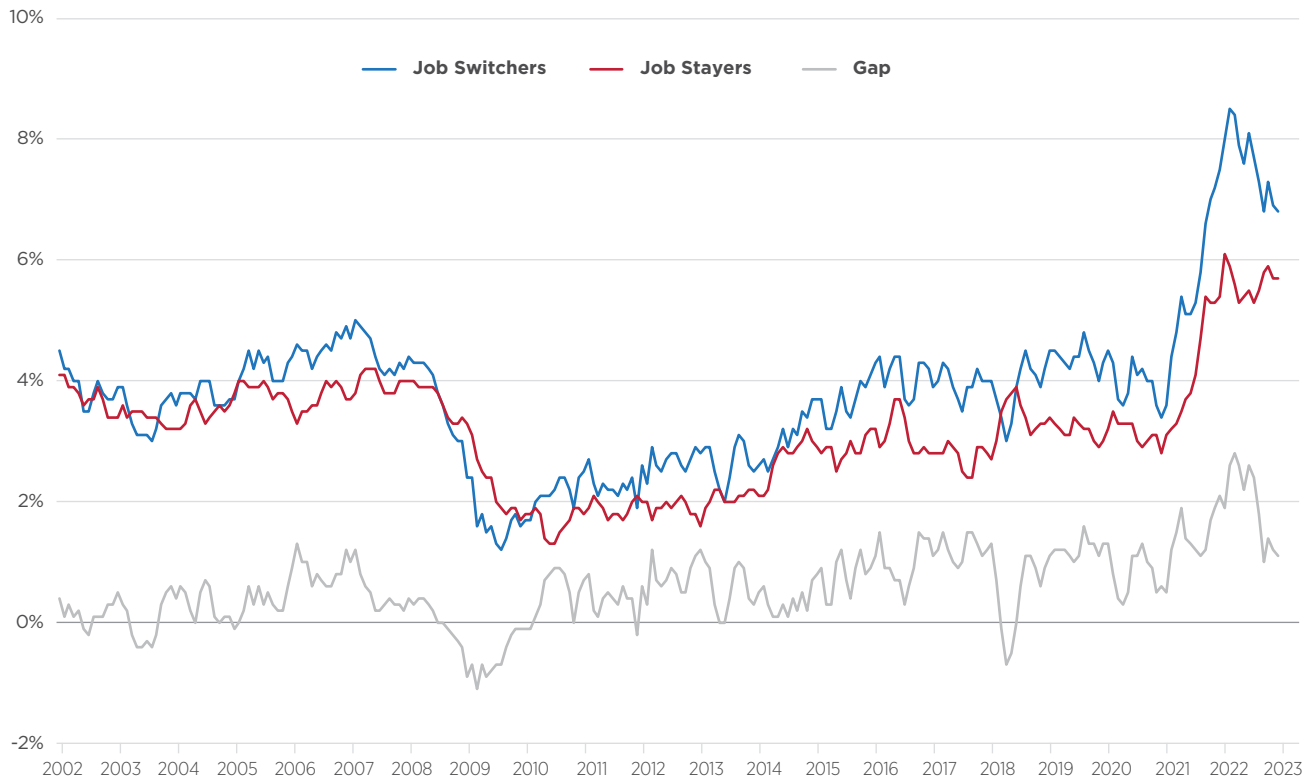
Source: Bureau of Labor Statistics

Typically, salary increases for existing employees (which can be likened to wage growth for those who remain in their jobs) tend to trail behind wage growth for new hires.

Roughly two years ago, wage growth for job switchers sped up much more rapidly than for

job stayers (who make up the vast majority of workers). This resulted in the largest ever recorded disparity between the two. Over the past year, wage growth for job switchers has slightly slowed, while wage growth for job stayers is still in the process of catching up.

Atlanta Fed Wage Tracker – 12-month growth rate



Source: The Federal Reserve Bank of Atlanta

Not surprisingly, this creates quite an incentive for workers to better their lot by seeking new employment. Although overall quit rates are gradually decreasing, they still well surpass pre-pandemic levels. However, this trend doesn't hold true for every industry, with significant

variation across sectors. In general, quit rates in industries associated with manual labor remain noticeably above pre-pandemic levels, but this isn't the case for sectors with considerable white-collar employment.

Still-high inflation is likely to lead to more Fed rate hikes

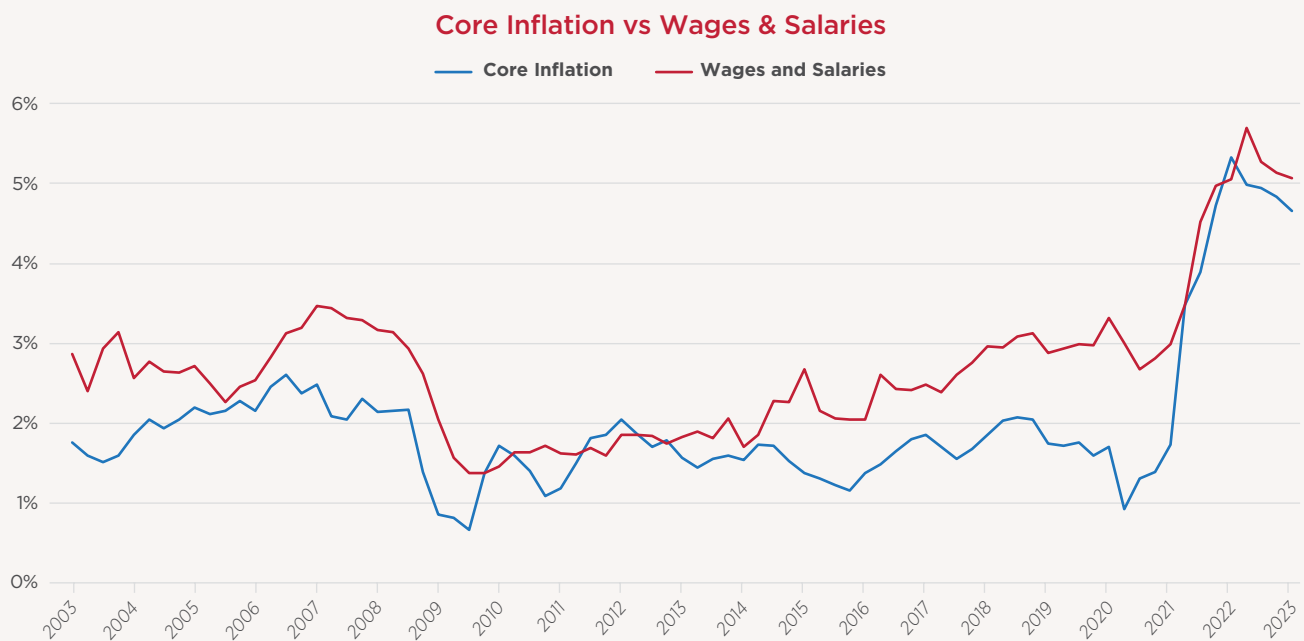
A growing consensus suggests that the tight labor market and rapid wage growth are key drivers of the persistent inflation we have been experiencing. A recent White House blog provides further evidence for this, highlighting a wage-sensitive section of the services economy that is currently experiencing inflation rates three times higher than the pre-pandemic period.

While inflation is gradually decreasing, the persistently tight labor markets suggest its current path may be to stabilize at around 3.4-4%, which is much higher than the Federal Reserve's target of 2%. If inflation remains in this range for an extended period, inflation expectations will likely adjust to match this rate. This makes it significantly more challenging to reduce inflation back to the 2% target.

Under typical circumstances, when the unemployment rate stands at 3.6%, the economy has added 732,000 jobs in the past three months, and both wage growth and core inflation are rising at a rate of approximately 4.5-5%, one

might expect the Federal Reserve to increase interest rates aggressively. However, these aren't entirely normal times. In June, the Federal Reserve opted not to raise rates, although they signaled two more likely rate hikes in 2023.

The most plausible scenario for the coming months includes continued sluggish economic growth, decelerating job growth, and inflation hovering in the 3-4% range. The Federal Reserve is much more likely to raise rates than to lower them. A recession is still a possibility by the end of 2023. Nevertheless, even if the U.S. does experience a recession, we anticipate the number of layoffs to be relatively modest. This is due to two factors: first, any potential recession is likely to be mild, and second, having experienced the trauma of post-pandemic labor shortages, employers may hesitate to freeze hiring, choosing to preserve flexibility for recovery by maintaining a larger workforce even as business activity slows or to rebalance their workforce through attrition.



Source: Bureau of Labor Statistics

Two labor markets for two different sets of workers

Overall, labor markets for manual work occupations are running far tighter than others. These sectors are experiencing unusually high turnover rates and wage growth. Wages in blue-collar and manual services jobs have escalated

at rates much greater than for white-collar jobs. This trend has resulted in a reduction in the wage advantage of a college degree, when compared to vocational associate and high school degrees.

Employment Cost Index (salaries and wages) YoY % Change

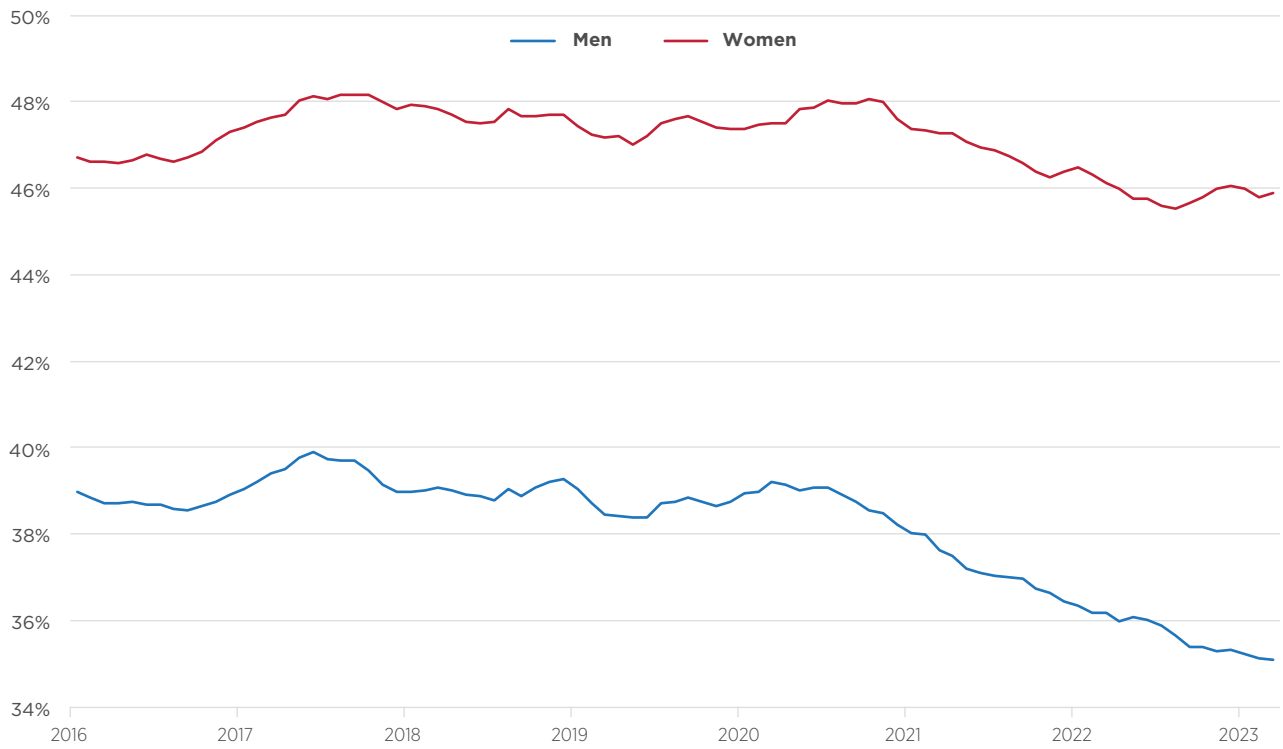


Source: Bureau of Labor Statistics

The swift wage escalation in blue-collar and manual services occupations, coupled with the diminishing wage premium for a college degree, has lessened the appeal of pursuing higher education. This is possibly one of the principal causes behind the recent significant decrease in college enrollment among the 18-to-21-year-old population – a decline that has been more pronounced among men than women.

This education recession could have longer term consequences for the American economy and American competitiveness on the global stage than any economic downturn we might experience over the months ahead. We look forward to exploring this further in a forthcoming paper.

Percent enrolled in college, 18-21 age group, 12-month moving average



Source: Bureau of Labor Statistics and the Burning Glass Institute

